



Funds in Focus 2019

Private Funds Annual Review Conference

Estate Planning and Family
Office Considerations for Fund
Owners and Managers

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Estate and Gift Tax Rules

- Federal Estate and Gift Tax Rules for U.S. Citizens
 - Federal Unified Estate and Gift Tax Credit
 - 2019 - \$11,400,000; 2020 - \$11,580,000
 - Gift Tax
 - \$15,000 per person annual exclusion
 - Tuition and medical expenses paid directly to provider don't count against annual exclusion
 - Unlimited marital deduction
- Different rules for non-US citizens
- State Estate Tax—much smaller exemptions (NY \$5.74 million increasing to \$5.79 million in 2020; NJ, FL, and CA have no state estate tax)

End-of-Year Planning

- Charitable giving
 - Donor-advised fund vs. private foundation
 - Cash gift to public charity deductible up to 60% of AGI; cash gift to private foundation deductible up to 30% of AGI (excess deductions can be carried forward for up to 5 years)
 - Gifts of appreciated stock to public charity deductible up to 30% of AGI and deductible at FMV; gifts of appreciated stock to private foundation deductible up to 20% of AGI and deductible only at basis unless certain requirements are met (e.g. stock is publicly traded and is LTCG property)
- Charitable lead annuity trust (“CLAT”)—CLAT is treated as private foundation for deduction limitations

Private Placement Life Insurance

- Purposes of life insurance generally are:
 - Replace lost income (single-life)
 - Provide cash to pay estate taxes (second-to-die)
- PPLI allows customization of investments within policy
- Assets are held in “insurance-dedicated funds”
- Investment returns accumulate on tax-deferred basis
- Insurance proceeds received by beneficiary, including accumulated investment gains, are exempt from income tax
- BUT requires careful adherence to diversification and investor-control requirements—you generally can’t invest the policy in your own fund

Family Offices

- Dodd-Frank “family office rule”—must meet regulatory requirements
 - May have only family clients
 - Must be owned and controlled by family members
 - Can’t market itself to public as an investment adviser
- Typical considerations:
 - Tax planning—deductibility of investment management expenses
 - Family trusts as investors in the family office
 - Employment of “outsiders”/employee benefits

Planning with Carried Interests

- Fund Manager of new private equity fund might own:
 - Carried interest through GP
 - Capital interest through GP
 - Capital interest directly in the fund as an LP
 - Interest in management company
- Fund Manager may want, at initial creation of fund:
 - To transfer carried interest to trust for descendants
 - To value carried interest at zero for gift tax purposes
 - To retain ownership of capital interests and of any interest in the management company
 - To make all necessary capital contributions out of his or her pocket

Problem: IRC Section 2701

- Section 2701 applies where a taxpayer transfers to family members (whether by sale or gift) a “junior” interest in an entity, while retaining a “senior” interest
 - Congressional concern is that, post-gift, the senior interest holders will manipulate the entity structure to push value to the junior interest
 - To prevent this, Section 2701 provides that if a taxpayer only transfers a junior interest, he or she will be deemed for gift tax purposes to have also transferred any retained senior interest – ***potentially resulting in an unexpected taxable gift***
 - In a typical fund structure, the capital interest is “senior” to the carried interest for purposes of Section 2701
- Fund Manager should not transfer carried interest in isolation – instead, transfer with other economic interests

“Vertical Slice” Transfer

- Section 2701 has a safe harbor for transfers that consist of a “vertical slice” of the entirety of the assignor’s economic interests in the fund
 - This vertical slice is most easily achieved by having the Fund Manager contribute all of his or her (1) carried interests and (2) capital interests (whether through the GP or the LP) to an LLC that is wholly owned by the Fund Manager
 - The Fund Manager can then gift or sell a percentage (or all) of the LLC interests to a trust for descendants

“Vertical Slice” Transfer (cont’d)

- Section 2701 is not clear as to whether the vertical slice must include the grantor’s interest in the management company
 - Many practitioners are comfortable not including, as long as the management company does not have an economic interest in the fund (i.e., no compensation via carried interest or based on profits)
 - A management company compensated based on a percentage of assets under management can likely be excluded from the vertical slice
 - A management fee offset complicates this analysis

Administering the LLC

- If the Fund Manager gifts an LLC interest a trust, he or she should not act as the LLC Manager (although the Fund Manager can be given the power to control LLC investments)
- The LLC is responsible for making all capital contributions with respect to its fund interest
 - The LLC, in turn, must obtain the necessary capital pro rata from its members.
 - If the trust does not have sufficient assets to pay its portion, either (1) the Fund Manager will need to make a cash gift to the trust or (2) he or she will need to make a loan to the LLC

Administering the LLC (cont'd)

- LLC ownership must be respected by fund – all contributions and distributions must come to or from the LLC
- If Fund Manager later wants to make an additional investment in the fund (such as by buying out the interests of a departing employee), it is advisable to make the additional investment through the LLC

Problem: Valuation

- Carried interest generally has value, even before a fund has commenced investing
 - A professional appraiser needs to be engaged to determine value for gift tax purposes. Important valuation factors include (1) track record of prior funds and (2) expected capital raise
 - Value is lowest at fund formation, increasing as time passes and capital is successfully raised and deployed
- Capital interest generally has no value until a capital contribution is made
 - Once capital is contributed, the appraiser will apply a valuation discount to reflect illiquidity of capital interest

Problem: Valuation (cont'd)

- If fund interests were gifted, the grantor must timely file a gift tax return reporting the gift, with a written appraisal attached
- If fund interests were sold, the seller should consider filing a gift tax return to commence the three-year statute of limitations
- The return must provide “adequate disclosure” of the transaction

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